CENTER FOR RESPONSIBLE LENDING

Michigan House of Representatives
Banking and Financial Services Committee Hearing
Predatory Lending Practices and Potential Legislative Solutions

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Introduction

Mr. Chairman, members of the committee, thank you for the opportunity to testify before you today on such an important topic – the subprime lending crisis.

I am Christopher Kukla, director of state legislative affairs for the Center for Responsible Lending (CRL). CRL is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL began as a coalition of groups in North Carolina that shared a concern about the rise of predatory lending in the late 1990s.

CRL is an affiliate of Self-Help, which consists of a credit union and a non-profit loan fund. For the past 26 years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans. Self-Help has provided over $5 billion of financing to over 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country, with an annual loan loss rate of under one percent. We are also a responsible subprime lender. In addition to making direct loans, Self-Help encourages sustainable loans to borrowers with blemished credit through a secondary market operation. We buy these loans from banks, hold on to the credit risk, and resell them to Fannie Mae. We have used the secondary market to provide $4.5 billion of financing to 50,000 families across the country, loans that have performed well and significantly increased these families' wealth, giving many families their chance to rise into the middle class.

I want to make three main points today.

First, Michigan is facing a significant number of foreclosures. The Congressional Joint Economic Committee recently reported that there are more than 275,000 outstanding subprime loans in Michigan, and between the 3rd Quarter of this year and the end of 2009, 65,000 will end in foreclosure.[1] Further, the JEC estimates that the cumulative loss of property values of these foreclosures at over $3 billion, and a loss of an estimated $39 million in lost property taxes.[2] Beyond the borrowers who lose their homes to foreclosure, it is estimated that every foreclosure

[1] *The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here,* Report prepared by the Majority Staff of the Joint Economic Committee, found at http://jec.senate.gov/Documents/Reports/10.25.07OctoberSubprimeReport.pdf.
[2] *Id.*

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reduces property values for homes within ¼ mile by $3,000. Even those who did everything right suffer from foreclosures nearby.

Second, the market is <u>not</u> correcting itself. Incentives to make bad loans remain firmly in place. All evidence indicates a lack of self-correction, including recent reports on investment securities backed by subprime mortgages.

Third, Michigan consumers should be protected to ensure that the abusive lending tactics that led to this problem are not repeated in the future. Strong action will serve two purposes. Strong action will prevent future abuses and will drive bad lenders out of the marketplace in search of states with less regulation.

Immediate legislative or regulatory action is needed from Michigan in two major areas:

- **Assisting Homeowners Threatened with Foreclosure**: Responsibility rests with lenders, servicers, investors and trustees to stem the tide of foreclosures by proactively modifying loans to make them sustainable. There is no longer any dispute that brokers and lenders have placed borrowers into loans that set them up for failure, and the secondary market provided key support and high demand for this reckless lending. However, there are a number of concrete steps that Michigan can take today to help current borrowers, minimize foreclosures and stabilize housing markets. Most urgently, Michigan should provide emergency funding for foreclosure prevention counseling and legal assistance. In addition, the state should hold the mortgage industry accountable for actions to avoid foreclosures and should call upon lenders and servicers to provide broad-scale sustainable loan modifications.

- **Protecting Future Borrowers:** Michigan must establish strong and enforceable statutory underwriting standards to prevent a repeat of this crisis as well as protect current borrowers facing payment shock. Implementing statutory requirements on at least all subprime and nontraditional loans—including an assessment of a borrower's ability to repay, requiring escrow for taxes and insurance and income verification, and increasing accountability at all stages of the mortgage transaction and crafting a meaningful enforcement framework that enables state regulators to be more effective—will allow the state to promote real, long-term sustainable homeownership.

I. Michigan Faces a Significant Number of Foreclosures.

Because of reckless lending practices in the subprime market and voracious investor demand for the resulting loans, last December the Center for Responsible Lending estimated that 2.2 million families nationwide—and in Michigan we project that 20% of subprime loans made in 2006 will end in foreclosure—have lost or will lose their homes to foreclosure. These foreclosures already are occurring in record numbers, and the worst is still ahead.

Since then, hardly a week has gone by where new and increasingly ominous reports and press accounts of the mounting foreclosure crisis are not prominently featured on front pages across the state. These accounts have vividly captured the human and neighborhood costs of foreclosures. But they also suggest an industry that responds to press coverage on individual stories, while leaving in act a system that is too often failing to treat borrowers fairly.

Subprime loans have and will continue to represent the largest and far disproportionate share of Michigan foreclosures.

States like Maine, Minnesota, Ohio, and North Carolina have enacted strong and bold legislation to supplement federal guidance and Massachusetts has recently enacted strong regulations to supplement its laws. Michigan has not acted now, nor has Michigan even responded effectively to equity stripping practices that still pervade the subprime market, even today.

We would recommend that the Michigan Legislature act in 2008 to provide adequate protections for borrowers in the future.

II. The Market is Not Self-Correcting

Despite the widespread assumption that the market has corrected itself, we have yet to see evidence that lenders have significantly changed their practices. Standard & Poor's recently announced that it had downgraded 1,713 classes of residential mortgage-backed securities (RMBS) backed by subprime and Alt-A mortgages issued in the first half of 2007.[3] Similarly, a recent market analysis by an investment management firm, FBR Capital Markets, notes that the default rate on loans included in RMBS increased dramatically between July and August this year.[4] For RMBS made up of adjustable-rate subprime loans, the default rate increased by 44% in August over the previous month, and even for securities with fixed-rate subprime loans, the increase was 36%. The FBR analysis is clear in blaming high default rates on lax underwriting practices, and the report notes that as of June 2007, "We find little difference between the salient risk characteristics of subprime loans originated in 2007 and 2006."[5]

Moreover, advertisements for dangerous loan products still abound. For example, click on the ubiquitous popup internet ad for LowerMyBills.com—it's the one with the dancing alien and other animated creatures—and you'll be given an opportunity for a "deep discount" on a loan – most likely, a payment option ARM. And Chevy Chase Bank recently sent a flyer to its brokers featuring the excited announcement, "Good New Travels Fast: Stated Income is Back!" Attached to that announcement are guidelines and a rate sheet that show not only is the bank still making stated income loans, but even retirees on fixed incomes can get them.[6]

The truth is, the subprime mortgage market as currently structured doesn't have adequate incentives to change its practices. To the contrary, as long as the subprime market continues running without adequate rules, brokers and lenders will continue to make any type of loan that Wall Street will buy. While the mortgage industry has argued for years that regulation of subprime lending would have the unintended consequence of restricting credit, it is now apparent that the recent credit crunch was a consequence of the <u>lack</u> of adequate regulation and the reckless lending that followed. If subprime lenders had been subject to reasonable rules—the

[3] "S&P downgrades 1,713 classes of mortgage-backed securities issued in the first half of 2007," Associated Press (October 17, 2007).
[4] FBR Capital Markets, "Structured Finance Insights," FBR Investment Management, Inc. (September 28, 2007).
[5] FBR Capital Markets, note 14 at p. 2.
[6] Copies on file with the Center for Responsible Lending.

kind of rules that responsible mortgage lenders have always followed—we wouldn't have the problems we're seeing today. The market may tighten up temporarily, but with so much money at stake, future abuses are inevitable.

III. What Can We Do?

CRL proposes that Michigan take immediate action in the following areas, discussed in more detail below:

I. Assist Homeowners Threatened with Foreclosure

A. Increase Sustainable Loan Modifications
B. Provide Emergency Funding for Foreclosure Prevention Counseling and Legal Services
C. Develop New Products and Rescue Funds

II. Protect Future Homeowners

A. Return to Common-Sense Lending Guidelines
   a. Ability to Repay
   b. Income Verification
   c. Impoundment Accounts (Escrow of Taxes and Insurance)

B. Align Financial Incentives with Borrower Needs
   a. Ban Prepayment Penalties on All Subprime Loans
   b. Prohibit Steering
   c. Ban Yield-Spread Premiums

C. Restore Accountability for Loans Throughout the Mortgage System
   a. Broker Accountability
   b. Lender Responsibility
   c. Investor/Assignee Liability

I. **Assisting Homeowners Threatened with Foreclosure**

Providing assistance and relief to current borrowers faced with defaults and/or foreclosure actions is a pressing priority. We propose three strategies for the state to implement:

Direct mortgage servicers and lenders to make meaningful and sustainable modifications to existing loans at scale, creating automated loan modification formulas and state data collection and monitoring systems; establish emergency funding support for foreclosure prevention counseling and legal services; and, using models provided by Massachusetts, New York, Pennsylvania and Ohio, create targeted refinance products and/or establish a rescue fund for borrowers who would not qualify for refinance or modifications.

A. **Making Loan Modifications Work:** Loan modifications offer the most promising alternative for both borrowers, taxpayers and the healthy functioning of mortgage markets in the future. In fact, Federal Deposit Insurance Corporation Chair Sheila Bair recently announced that mortgage lenders should voluntarily rewrite the millions of the nation's subprime loans that are poised to reset to levels borrowers cannot afford to repay.[7] Ms. Bair would like to see these adjustable-rate mortgages converted to fixed-rate loans at the lower variable rate. Subprime borrowers "need a better deal," Ms. Bair wrote in *The New York Times*, "One that they can afford." Even the more conservative *Wall Street Journal* editorial page has endorsed this approach:

> "Yes, the banks would have to accept a lower income stream, but that's better than taking the write-off from a foreclosure. As many as a million borrowers nationwide might benefit from such treatment, and for hundreds of thousands it could mean keeping their home. We understand the delicacy of asking banks to rewrite their contracts, which is why Ms. Bair says this should be voluntary. But if there's a case of enlightened business self-interest, this is probably it."[8]

For borrowers, loan modifications provide the best opportunity to avoid the loss of their homes – ideally with long-term affordable mortgages. The best modifications, as recommended by the FDIC, will convert the existing adjustable rate mortgage to a long-term fixed rate mortgage at the original introductory interest rate for the life of the loan. This type of adjustment should be sufficient to achieve affordability for borrowers in markets that have not experienced significant price declines. Moreover, these initial rates were already risk-adjusted and substantially exceeded prime rates.

For borrowers in markets with steep price declines, deeper modifications may be necessary. For these borrowers, it still may be economically prudent for servicers to reduce the interest rate or the loan balance, rather than face the even higher costs of foreclosures.

For taxpayers, modifications minimize the negative consequences of foreclosures and prevent the need for large infusions of taxpayer subsidies to avoid them. Specifically, concentrated foreclosures serve to depress the prices of nearby homes. Researchers found that, in Chicago, a foreclosure on a home lowered the price of other nearby single-family homes, on average, by 1.44 percent. They also reported that the downward pressure on housing prices extended to houses that sold within two years after the foreclosure of a nearby house.[9] Additional data cited in the recent Joint Economic Committee report on the subprime lending crisis found that, on average, home values on a block decline by 9.1% in the case of one abandoned home; values decline by an average of 15.0% for five abandoned homes.[10] Concentrated foreclosures can also lead to higher municipal costs, as local governments step in to maintain the security and appearance of vacant homes in their communities.[11]

In addition, wide utilization of loan modifications can reduce the need for public resources to assist in providing affordable refinance options for subprime borrowers. To date, a number of states have announced new publicly-funded pools to fund refinance loans for borrowers at risk of foreclosure. States that have developed these funds include Ohio, New York, Massachusetts and Colorado.

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[7] Sheila C. Bair, "Fix Rates to Save Loans." *The New York Times*, October 19, 2007.
[8] "Mortgage Meltdown," Wall Street Journal, October 24, 2007; Page A20
[9] Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," p. 57, 69, 72, 75 *Housing Policy Debate* (17:1) Fannie Mae Foundation (2006).
[10] "The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here," Report and Recommendations by the Majority Staff of the Joint Economic Committee. October 2007.
[11] Erik Eckholm, "Foreclosures force suburbs to flight blight," *The New York Times*. March 23, 2007.

For mortgage markets, modifications keep market incentives firmly in place. Modifications will ensure that losses are borne by the lenders and investors who are responsible for making loans without adequately evaluating the borrower's ability to repay them. As long as any losses resulting from the loan modifications (relative to the original loan terms) are less than the losses that would result from a foreclosure, implementation of modifications is consistent with the servicers' requirements to maximize cash flows for the investors in securities as a whole.

Need for Accountability and Standardization and in Modifications

In preparation for the dramatic increases in loan resets, servicers report that they are now expanding their loss mitigation efforts, adding staff and employing new efforts to contact borrowers early to prepare for the reset. The American Securitization Forum, an industry group has produced a *Statement of Principles, Recommendations and Guidelines on Modifications* to its members.[12]

While lenders profess a desire to avoid foreclosures, there are few mechanisms in place to track the outcomes for borrowers who participate in loss mitigation efforts. A recent survey of the top loan servicer found that only 1 percent of subprime ARMs reaching their reset date were being modified. No data are regularly reported by lenders as to how many borrowers who participate in loss mitigation efforts avoid foreclosures, nor on the terms of any loan modifications they receive.

Finally, we believe that it will be important for the highest levels of legislative leadership and the executive branch to use their political leverage to encourage servicers to execute much broader scale modifications. The data system is a great tool for tracking progress, but to date the lenders have been unwilling or unable to deliver many modifications. Making this a top state political priority like health care and education could change the dynamics for lenders and damaging economic consequences.

State policymakers should also work with servicers to develop transparent and objective standards for loan modifications. Under current practice, each loan modification is developed on a case-by-case basis, subject to the financial circumstances of individual borrowers. There is little transparency for borrowers to know the best terms for which they could qualify and no guarantees that similarly situated borrowers will be treated equally. Having more streamlined and objective standards in place should simplify and streamline the modification process, and allow more consistent and successful results for borrowers and lenders. These standards would also avoid potential fair housing issues.

B. **Developing a State-Backed Refinance Mechanism:** As noted above, a number of states have utilized bond funds to develop refinancing products for borrowers at risk of foreclosures, including Massachusetts, New York, Pennsylvania and Ohio. These pools have been limited and targeted to assist low-income households. Some states have applied other restrictions, such as

[12]American Securitization Forum, *Statement of Principles, Recommendations and Guidelines on Modifications,* June 2007 found at http://www.americansecuritization.com/uploadedFiles/ASF%20Subprime%20Loan%20Modification%20Principles_060107.pdf

excluding investor-owned properties. Many states are partnering with larger financial providers, like Fannie Mae and Freddie Mac, to allow their limited resources to serve more families.

Most importantly, it is critical that any state-backed resources be contingent upon significant financial concessions by the servicers and investors. Such resources should not be used to make investors whole, and thus serving to bail them out of bad investment decisions. These concessions could include refinancing at no more than 90 percent of the current appraised value or even the estimated foreclosure value of the property, whichever is less.

II. <u>Protect Future Homeowners</u>

Michigan has belatedly followed the lead of the federal regulators in establishing new lending standards for subprime loans. Other states have shown much greater leadership both in establishing tougher lending standards, and in strengthening procedures to rein in deceptive practices of brokers and lenders. Much stronger legislative action is needed to ensure that subprime borrowers get access to responsible credit that provides sustainable homeownership opportunities.

A. Return to Common-Sense Lending Guidelines

a. <u>Establish Legislative Ability to Repay Standards</u>

Approving loans without evaluating a borrower's ability to repay is an unfair and deceptive practice that does not benefit borrowers. Through this practice, borrowers are deceived into thinking that they can afford a loan, and then when rates increase after the two- or three-year introductory period, they are faced with the ultimate of injuries: the loss of their home and hard-earned equity.

The federal regulatory subprime statement sets out very basic guidance only. Although the Statement is stronger than current regulatory standards, it provides only regulatory guidance. It is not clear that the state will have adequate capacity to enforce the guidance, and individual borrowers have limited access to remedies for the shortcomings of their brokers or lenders.

Stronger, enforceable statutory standards should be established.

Lenders should be required to underwrite all loans based on the fully-indexed rate and fully amortizing payments, while using a debt-to-income standard (DTI) that considers property taxes, hazard insurance, and other debts. Anti-predatory lending laws in Maine, Minnesota, Ohio and North Carolina provide good models. Factors to consider should include whether there are other verified resources available to the consumer for making payments on the loan, the consumer's current expenses, and whether there are adequate resources available to cover family living expenses after deducting debt service requirements from monthly income.

b. Require Appropriate Documentation of Income

Verification of income is a necessary complement to effective implementation of an ability-to-pay standard. While lenders purport to evaluate borrowers and underwrite loans, in reality, without adequate income verification, a lender's approval of a loan is meaningless. Borrowers often do not understand that they are paying a higher interest rate in exchange for not documenting their income, even though their W-2s are readily available, or that their income is overstated. Stated income loans hurt borrowers by creating opportunities for overreaching, and, in fact, have been proven to overstate incomes and payment ability, and therefore increase foreclosures. For example, a review of a sample of "stated-income" loans disclosed that 90 percent had inflated incomes compared to IRS documents, and "more disturbingly, almost 60 percent of the stated amounts were exaggerated by more than 50 percent."[13]

Fitch Ratings recently noted that "loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector . . ."[14] "Low doc" and "no doc" loans originally were intended for use with the limited category of borrowers who are self-employed or whose incomes are otherwise legitimately not reported on a W-2 tax form, but lenders have increasingly used these loans to obscure violations of sound underwriting practices.

Michigan should require lenders to verify and document all sources of income using either tax or payroll records, bank account statements or any reasonable alternative or third-party verification, including non-traditional sources including rental payment records, utility payments or remittances.

c. Require Impoundments (or Escrows) for Taxes and Insurance

In stark contrast to the prime mortgage market, most subprime lenders make loans based on low monthly payments that do not impound (or escrow) for property taxes or hazard insurance. By routinely omitting escrows for taxes and insurance, subprime lenders have deceived borrowers into believing that their mortgage will be affordable. This deceptive practice is also unfair because borrowers are often forced to refinance their mortgage in order to raise the funds to pay their taxes and insurance, needlessly causing substantial injuries of approximately 8% of the loan amount (3% in upfront points and fees, 2% in third party fees, 3% in prepayment penalties), or $24,000 for a $300,000 loan.

Michigan should require that all subprime loans both (A) include the cost of hazard insurance and property tax escrows in their ability to repay analysis of a subprime loan; and (B) establish escrow or impoundment accounts for such taxes and insurance.

B. Align Financial Incentives with Borrower Needs

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[13] Mortgage Asset Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006); *see also* 2007 Global Structured Finance Outlook: Economic and Sector-by Sector-analysis, FITCH RATINGS CREDIT POLICY (New York, N.Y), December 11, 2006, at 21, commenting that the use of subprime hybrid arms "poses a significant challenge to subprime collateral performance in 2007."

[14] See *Structured Finance: US Subprime RMBS in Structured Finance CDOs,* FITCH RATINGS CREDIT POLICY (New York, NY), August 21, 2006, at 4.

a. Ban Prepayment Penalties

Prepayment penalties are minimally addressed in the federal subprime statement, requiring only a grace period of 60 days before payment reset, during which a borrower must be able to refinance without paying a prepayment penalty.

Subprime prepayment penalties provide no economic benefit to borrowers. Some lenders have claimed that homeowners receive a lower interest rate in exchange for prepayment penalties, but subprime lenders' rate sheets tell a different story. Subprime rate sheets show that when borrowers get loans with prepayment penalties, mortgage brokers are allowed an extra commission known as a "yield spread premium." Prepayment penalties can cost borrowers thousands of dollars if they pay their loan early, and yield spread premiums increase the costs of the loan as well.

In fact, prepayment penalties serve to trap borrowers in high cost loans, or cause the borrower to lose significant home equity in order to escape them. They also limit the ability of responsible lenders to help borrowers refinance out of a loan at risk of ending in foreclosure.

Today prepayment penalties are imposed on about 70 percent of all subprime loans,[15] compared with about 2% of prime loans.[16] This disparity undermines the argument that subprime borrowers freely "choose" prepayment penalties. The unfairness of prepayment penalties is even more disturbing when you consider that they are more prevalent on subprime loans in communities of color. Borrowers in minority neighborhoods are more likely to receive prepayment penalties,[17] and minorities are at greater risk for receiving higher-priced loans than white borrowers, after controlling for legitimate risk factors.[18]

More than 35 states now regulate prepayment penalties, and at least ten states ban them outright. The recent trend is to ban prepayment penalties in the subprime market. North Carolina and Minnesota just banned prepayment penalties in subprime loans.

Like recent state laws in Minnesota and North Carolina and numerous Congressional proposals, Michigan should ban prepayment penalties for at least all subprime loans.

b. Prohibit Steering

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[15] *See, e.g.* David W. Berson, *Challenges and Emerging Risks in the Home Mortgage Business: Characteristics of Loans Backing Private Label Subprime ABS*, Presentation at the National Housing Forum, Office of Thrift Supervision (December 11, 2006). According to MBA data, there was a 69.2% penetration rate for prepayment penalties on subprime ARMs originated in 2006. Doug Duncan, *Sources and Implications of the Subprime Meltdown,* Manufactured Housing Institute, (July 13, 2007). A recent CRL review of 2007 securitizations showed a penetration rate for prepayment penalties averaging over 70%.

[16] *See* Berson, *supra* note 68. A recent MBA analysis shows that 97.6% of prime ARMs originated in 2006 had no prepayment penalty, and 99% of 2006 prime FRM had no penalty. Doug Duncan, *Sources and Implications of the Subprime Meltdown,* Manufactured Housing Institute, July 13, 2007

[17] Debbie Gruenstein Bocian and Richard Zhai, *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans*, Center for Responsible Lending (January, 2005).

[18] Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending (May 31, 2006).

Steering is the predatory lending practice of offering borrowers—particularly African-American and Latino borrowers and those with low to moderate incomes—a higher-cost loan when the borrower could actually qualify for a better rate or better terms.

Recent data illustrate that communities of color continue to pay more for homeownership than white borrowers: my organization, the Center for Responsible Lending, found in 2006 that for most types of subprime loans, black and Latino households are 30 percent more likely to be given a subprime loan even after controlling for legitimate risk factors.[19]

While pricing disparities can be the result of a variety of factors, including inconsistent application of objective pricing criteria, targeting of families of color by higher-rate lenders or brokers, and a lack of investment by lower-cost lenders in these communities, lenders and policymakers can take a multi-faceted approach to ensuring that all borrowers, regardless of race, receive loans that are fair and sustainable.

Michigan should curtail steering by requiring objective pricing standards to all subprime loans, and should hold lenders and brokers responsible for providing loans that are suitable for their customers.

III. Restore Accountability Throughout the Mortgage System

a. Broker Accountability

Mortgage brokers are individuals or firms who find customers for lenders and assist with the loan process. Brokers are independent contractors – they provide a way for mortgage lenders to increase their business without incurring the expense involved with employing sales staff directly. Brokers also play a key role in today's mortgage market: According to the Mortgage Bankers Association, mortgage brokers now originate 45 percent of all mortgages, and 71 percent of subprime loans.[20]

Brokers often determine whether subprime borrowers receive a fair and helpful loan, or whether they end up with a product that is unsuitable and unaffordable. Unfortunately, given the way the current market operates, widespread abuses by mortgage brokers are inevitable.[21]

Buying or refinancing a home is the biggest investment that most families ever make, and particularly in the subprime market, this transaction is often decisive in determining a family's future financial security. The broker has specialized market knowledge that the borrower lacks

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[19] Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, "Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages." Center for Responsible Lending. May 31, 2006. http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf

[20] MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006.

[21] Theoretically, the yield spread is paid, at the consumer's choosing, to lower closing costs. Empirically, that trade-off has not been found. See, *e.g.* Testimony of Howell E. Jackson, Senate Banking Committee Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums" (January 8, 2002), available at http://banking.senate.gov/02_01hrg/010802/jackson.htm#N_1_ ("Homeowners who are short on cash could, theoretically, use yield spread premiums to finance settlement costs. My study, however, offers compelling evidence that yield spread premiums are not being used in this way."); *See also* Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing* 44 Harvard J. on Leg. 123, note 94 and sources cited therein.

and relies on. The subprime mortgage market, as it is structured today, gives brokers strong financial incentives to sell excessively expensive loans to borrowers.

Experts on mortgage financing have long raised concerns about problems inherent in a market dominated by broker originations. For example, the chairman of the Federal Reserve Board, Ben S. Bernanke, recently noted that placing significant pricing discretion of mortgage loans in the hands of financially-motivated mortgage brokers can be a prescription for trouble, as it can lead to behavior that violates fair lending laws.[22] A report issued by Harvard University's Joint Center for Housing Studies concurred: "Having no long term interest in the performance of the loan, a broker's incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear."[23]

In summary: Mortgage brokers, who are responsible for originating over 70 percent of loans in the subprime market, have strong incentives to make abusive loans that harm consumers, and no one is stopping them. In recent years, brokers have flooded the subprime market with unaffordable mortgages, and they have priced these mortgages at their own discretion. Given the way brokers operate today, the odds of successful homeownership are stacked against families who get loans in the subprime market.

To make brokers accountable, Michigan should place statutory duties for brokers and mortgage company lenders to borrowers, enforced by new bonding requirements and a right of private action for injured borrowers to seek remedies.

c. Investor/Assignee Liability

The secondary market for subprime loans lies at the heart of today's mortgage meltdown. Back in the days when families went to their local savings and loan to get a mortgage and the thrift held that loan among its own investments, the interests of borrowers and lenders were perfectly aligned: if the borrower did not pay the mortgage, the lender did not make money. But the growth of the secondary market upset that core alignment of interests between lender and borrower by creating a system where each actor was compensated early in the loan transaction, often within the first month of the loan, thereby reducing the incentive to worry about how the borrower would fare later on.[24]

Independent mortgage brokers originate most subprime loans, and receive their compensation from a lender immediately upon brokering the loan. That lender turns around and sells the loan into the secondary market, where it is bundled together with other mortgages and sliced and diced into securities. These securities are then sold to investors, who retain the right to collect payments and enforce the mortgage terms, including foreclosing on the home if the borrower defaults.

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[22] Remarks by Federal Reserve Board Chairman Ben S. Bernanke at the Opportunity Finance Network's Annual Conference, Washington, D.C. (November 1, 2006).

[23] Joint Center for Housing Studies, "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community-Based Organizations," Harvard University, p.4-5. Moreover, broker-originated loans "are also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors." Id. at 42 (citing Alexander 2003).

[24] Chairman Bernanke makes this point in a recent presentation: "Housing, Housing Finance, and Monetary Policy, remarks by Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System at the Federal Reserve Bank of Kansas City's Economic Symposium – Jackson Hole, Wyoming (August 31, 2007), pp. 16 – 17.

As the subprime market grew, Wall Street wanted more and more of these loans offering higher-risk investments with potential for higher returns. The demand from Wall Street was so intense that it encouraged subprime lenders to abandon reasonable qualifying standards, to forget about standard documentation requirements, and to ignore whether borrowers could actually afford the loan. Lenders created new, dangerous loan products that appeared deceptively affordable to borrowers, and brokers pushed these products to earn high fees. After filing for bankruptcy, the CEO of one mortgage lender explained it this way to *The New York Times*, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans," he said. "What would you do?"

Or as Alan Greenspan recently told *Newsweek*, "The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford. We created something which was unsustainable. And it eventually broke. If it weren't for securitization, the subprime-loan market would have been very significantly less than it is in size."[25] Wall Street rating agencies also turned a blind eye to the increasingly high volume of poorly underwritten, extremely dangerous loans included in mortgage investments. Paid by the securitizers to rate the tranches, the agencies overlooked loans that any experienced underwriter would have known were headed for foreclosure, giving an AAA rating to the majority of the tranches created.[26]

The result of this buck-passing was the market meltdown of this summer, which now seems to be continuing into the fall. One market watcher recently observed that "Anything securitized in 2007 has got to have the worst collateral performance of any trust I've seen in my life."[27]

The best way to re-align the interests of borrowers and lenders is for Michigan to adopt meaningful assignee liability. Since most mortgage loans are sold on the secondary market, it is essential that secondary market liability create incentives for the market to police itself. When assignee liability exists, the borrower is allowed to pursue legal claims against the assignee when the loan transaction involves illegal actions or abusive terms. In the case of the mortgage market, strong assignee liability would mean that when investors purchase high-risk mortgages, with all the corresponding financial benefits, they also accept reasonable liability for when the mortgages prove to be abusive and harm homeowners. If a loan goes into foreclosure as a result of abusive or illegal practices, the borrower would be able to pursue legal action that might save his or her home.

Like New Jersey and Massachusetts, Michigan should require assignee liability to ensure that the secondary markets help to provide accountability for loan originations.

IV. Conclusion

[25] "The Oracle Reveals All," *Newsweek* (Sept. 24, 2007) pp. 32, 33.
[26] *See, e.g.* Allan Sloan, "An Unsavory Slice of Subprime," *Washington Post* (October 16, 2007) ("Even though individual loans … looked like financial toxic waste," 68% of the issue was rated AAA.)
[27] Shannon D. Harrington and Mark Pittman, "Subprime Delinquencies Accelerating, Moody's Says," (October 5, 2007), available at http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=a8Mzhz09jHP8

Today we are seeing massive disruptions in the financial markets following years of reckless lending on subprime mortgages. This issue has been prominent in the media recently, but the problems are not new. For years, housing analysts and many policymakers have known that most predatory lending occurs in the subprime market, and that subprime loans too often lead to foreclosure rather than sustainable ownership.

The foreclosure crisis has large potential implications for Michigan. Record numbers of borrowers are losing their homes. Declining housing prices are reducing the equity, wealth and spending of homeowners throughout the state. Jobs are already down sharply in the mortgage industry, and are rapidly disappearing from the home construction sector as well. Additionally, recent turmoil in global credit markets linked to the subprime lending crisis make the prospect of a housing-led recession a real possibility.

The legislature has the opportunity to draw upon the successful efforts in a number of states, and provide meaningful protections for borrowers in the future.